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EXCEPTION

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IN THE MATTER OF THE APPLICATION OF
ARIZONA PUBLIC SERVICE COMPANY FOR
AN ORDER OR ORDERS AUTHORIZING IT
TO ISSUE, INCUR, OR ASSUME EVIDENCES
OF LONG-TERM INDEBTEDNESS; TO
ACQUIRE A FINANCIAL INTEREST OR
INTERESTS IN AN AFFILIATE; TO LEND
MONEY TO AN AFFILIATE OR AFFILIATES;
AND TO GUARANTEE THE OBLIGATIONS OF
AN AFFILIATE OR AFFILIATES

DOCKET NO. E-01345A-02-0707

**EXCEPTIONS OF ARIZONA PUBLIC SERVICE COMPANY
TO RECOMMENDED OPINION AND ORDER**

Pursuant to A.A.C. R14-3-110, Arizona Public Service Company ("APS" or "Company") hereby submits its Exceptions to the Chief Administrative Law Judge's ("CALJ") Recommended Opinion and Order ("Recommended Order") in the above-captioned matter. APS' Proposed Amendments to the Recommended Order are attached as Appendix A.

I. INTRODUCTION AND SUMMARY OF APS EXCEPTIONS

APS agrees with much of what the CALJ has said in the Recommended Order and certainly is appreciative of her recognition that the financial situation facing Pinnacle West Capital Corporation ("PWCC") has the clear potential to adversely affect the Company and its customers. However, APS respectfully asks that the Recommended Order be amended in five general areas.

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1 First, the Recommended Order is ambiguous in several respects concerning the
2 extent of the authority actually granted, the conditions attached to such grant, and the
3 status of the process agreed upon by Staff and APS by which the most severe of these
4 conditions can be lifted or suspended. Because every word of a utility financing order will
5 be studied, analyzed and parsed by potential lenders to the Company, clarity is of the
6 utmost importance.

7 Second, the Recommended Order appears to impose new and unprecedented
8 restrictions on the ability of PWCC and its electric generation subsidiary, Pinnacle West
9 Energy Corporation ("PWEC") to acquire and sell "assets." If read literally, or without
10 further definition, these proposed new restrictions would both cripple these entities'
11 ability to conduct their business and inundate the Arizona Corporation Commission
12 ("Commission") in a nearly endless series of unnecessary regulatory proceedings.

13 Third, the Recommended Order revokes or suspends all previous waivers granted
14 APS and PWCC to A.A.C. R14-2-801, *et seq.*, commonly referred to as the "Affiliate
15 Rules." Such proposed action is based on vaguely-articulated criticisms of the Company's
16 successful efforts to plan for and meet its customers' needs under very challenging and
17 uncertain market conditions and in spite of changing regulatory demands—criticisms that
18 APS believes are unnecessary to the disposition of this case and factually groundless.

19 PWCC has invested over a billion dollars in new generation constructed by PWEC
20 within APS' service territory, including permanent generation resources within the Valley.
21 This generation was built to ensure that APS customers did not end up like those in
22 California, Nevada, the Pacific Northwest, and elsewhere—short of utility-owned or
23 controlled generation resources and at the mercy of a merciless and by the Commission's
24 own pronouncements, dysfunctional and manipulated wholesale market. Some may
25 consider those efforts to have been unnecessary when viewed from the safe vantage point
26 of today's depressed generation market. But that does not justify attributing to these good

1 faith intentions the sinister motives warranting the summary revocation of all the rule
2 waivers ordered by the Commission.

3 Fourth, and similar to the Company's third objection, there is no legal or factual
4 basis in this proceeding for launching an open-ended generic "investigation" of
5 unspecified and only vaguely-suspected violations of "Decision No. 61973, the Electric
6 Competition Rules, its Code of Conduct, and applicable law" (Recommended Order at
7 39). None of the circumstances cited in the Recommended Order can be properly
8 construed as even suggesting any wrongdoing on the part of APS or its affiliates despite
9 the unprecedented levels of market, financial and regulatory uncertainty during the past
10 three to four years.

11 Finally, the Recommended Order's discussion of this litany of imagined
12 transgressions by APS and its thinly-veiled criticisms of the manner in which APS and
13 PWCC sought to protect customers from the above uncertainties, both past and future, is
14 more than merely inaccurate. It could be construed as representing a premature and
15 potentially prejudicial pre-judgment on issues affecting the Commission's ultimate
16 determination of whether the Company should acquire any or all of PWEC's Arizona
17 generation and whether such generation should be included in APS' fair value rate base.
18 These are precisely the two issues that the Recommended Order (correctly) states are not
19 being determined or are even at issue in this Docket. *See* Recommended Order at 41.

20
21 **II. REVOCATION OR SUSPENSION OF THE WAIVERS TO A.A.C. R14-2-
22 801, ET AL., PREVIOUSLY GRANTED TO PWCC AND APS IS
23 UNWARRANTED OR, AT THE VERY LEAST, PREMATURE**

24 Pages 32 and 33 of the Recommended Order set forth the waivers that APS and
25 PWCC received in Decision No. 61973 (October 6, 1999) from the provisions of the
26

Affiliate Rules.¹ Certain of the waivers pertain to APS, while others affect only PWCC and its non-APS affiliates.² Decision No. 65434 (December 3, 2002) also granted APS a partial waiver of the Affiliate Rules in order to permit APS to provide an emergency \$125 million secondary line of credit for PWCC. This latter waiver would, by its own terms, expire in the fall of 2003. The Recommended Order, without adequate explanation or justification, revokes or suspends all of these waivers “during the term of the loan or guarantee.” *Id.* at 34.

No party to these proceedings, let alone any witness, suggested that such APS or PWCC waivers should be revoked or suspended. Neither APS nor PWCC received notice that Decision Nos. 61973 and 65434 were to be amended or rescinded in this or any other fashion merely as a result of APS filing a financing application under A.R.S. § 40-301, *et seq.* Nor were they granted any meaningful opportunity to address this issue at the hearing, both of which are required by A.R.S. § 40-252. Failure to afford affected parties notice and hearing required by statute is *per se* reversible error. *Southern Pacific Co. v. Arizona Corp.Comm’n.*, 98 Ariz. 339, 404 P.2d 692 (1965); *Tonto Creek Estates Homeowners Association v. Arizona Corp.Comm’n.*, 177 Ariz. 49, 864 P.2d 1081 (Ct. App. 1993).

Although Decision No. 65434 itself did indicate that the Commission would address the issue of “regulatory insulation” for APS in this Docket, a general allusion to this generic issue is hardly the sort of specific notice regarding amendment or rescission of Decision Nos. 61973 and 65434 required by A.R.S. § 40-252. Moreover, there is no

¹ Only certain portions of the Affiliate Rules are in effect, while others are only partially so. The Commission stayed the Affiliate Rules in Decision No. 56890 (April 26, 1990). Decision No. 58063 (November 3, 1992) only partially lifted such stay, which stay otherwise remains in force to this day.

² The Recommended Order refers to all such waivers as having been granted to APS. This is not technically accurate, as discussed above.

evidence in this record that revocation or suspension of the aforementioned waivers would contribute in any way to increased "regulatory insulation" of APS.

The partial waiver of Rule 803,³ and the corresponding limitation of the definition of "reorganization" in Rule 801(5), granted by Decision No. 61973 affect only PWCC and its non-APS affiliates, none of which were parties to this Docket or, for that matter, Docket No. E-1345A-02-0840, the Docket which resulted in Decision No. 65434 and included the language on "regulatory separation." Without such a waiver, every formation, reformation and dissolution of the myriad of limited partnerships, limited liability companies, or other business forms used by SunCor Development Company ("SunCor")⁴ or El Dorado Investment Company⁵ would be a "reorganization" under Rule 803. And each such "reorganization" could therefore require a filing with the Commission at least 120 days in advance. How does burdening PWCC's and the Commission's resources with dozens of such non-utility matters every year contribute in the slightest way to APS' "regulatory insulation?"

Rule 803, as modified in Decision No. 58063, also could prevent PWCC from providing PWECC with more than \$100 million in any single calendar year. Since PWCC has already invested approximately that amount in PWECC during 2003 to date, this revocation of Decision No. 61973's partial waiver of Rule 803 would mean that no further funds could be provided PWECC this year (or at least for 120 days). PWECC may then have inadequate resources to honor all of its contractual commitments to vendors or perhaps even to complete the construction of West Phoenix Combined-Cycle Unit No. 5,

³ Rule 803 has not been waived as to PWCC transactions affecting APS. Thus, the waiver granted by Decision No. 61973 is only partial. And as to PWECC, which is the only Rule 803 PWCC affiliate that is affected by the instant financing proceeding, the Commission specifically authorized its formation in Decision No. 61973 and found it to be in the public interest. Thus, PWECC exists in strict conformance with the Affiliate Rules and was not a result of the waiver granted PWCC by Decision No. 61973.

⁴ SunCor is a PWCC subsidiary engaged in real estate development.

⁵ El Dorado is a PWCC subsidiary engaged in venture capital investment.

1 potentially affecting reliability for the upcoming summer. The same issue would affect
2 PWEC's ability to continue with construction of Silverhawk, with its attendant impact on
3 PWCC and APS, as is discussed below.

4 In addition to being ineffective in achieving increased "regulatory insulation" of
5 APS, this amendment of Decision No. 61973 proposed by the Recommended Order is
6 actually counter-productive. Two principal features of what APS' Application in this
7 proceeding termed "the Recovery Plan" were features that did not impact APS or require
8 further Commission action. These were the accelerated sale of SunCor assets and the sale
9 to the Southern Nevada Water Authority ("SNWA") of 25% of the Silverhawk generation
10 project in Nevada. Both of these steps raise cash that is needed to repay PWCC's bridge
11 debt financing and thus eliminate the potential for requiring a larger loan from APS. And
12 both could now be adversely affected by the Recommended Order because such sales or
13 divestiture could entail the transfer or dissolution of ownership interests in legal entities
14 deemed to be "affiliates" of PWCC. Those transfers or dissolutions would also be deemed
15 "reorganizations" subject to the 120-day "prior notice" and hearing provisions of Rule
16 803. Delays in the construction of Silverhawk could result in a loss of SNWA's
17 anticipated \$100 million capital contribution to that project. These sorts of perhaps
18 unforeseen results flow directly from the Recommended Order's proposal to amend
19 Decision No. 61973 by revoking PWCC's limited waiver of Rule 803 and would only
20 increase PWCC's financial difficulties and place more resultant financial strain on APS.

21 On the APS side, none of the existing APS waivers from Decision No. 61973 deal
22 with any substantive provision of the Affiliate Rules. Rule 805(A), which is quoted in the
23 Recommended Order, is only an annual reporting provision. One of its provisions was
24 waived because it was largely duplicative of a later provision in the same rule, e.g., Rule
25 805(A)(2) and (A)(8). Another waived paragraph of Rule 805(A) was and will continue to
26 be covered by provisions of the APS Code of Conduct, both as approved by the

1 Commission in Decision No. 62416 (April 3, 2000) and under the revisions required by
2 the Commission in Decision No. 65154 (September 10, 2002). *See* Rule 805(A)(6) and
3 APS Code of Conduct, Section VIII and Policy & Procedure No. 1 "Affiliate Accounting
4 Policies." Lastly, contracts of the sort covered by the waived provisions of Rule
5 805(A)(9), (10) and (11), which would not have included the power sales agreement
6 between APS and PWCC, are provided to Commission Staff upon request. Importantly,
7 the financial data provided under Rule 805(A)(8), for which APS has neither requested
8 nor received a waiver, provide the dollar amount of all affiliate transactions affecting APS
9 and thus allows Staff to assess the significance of such affiliate agreements. Suspending or
10 revoking these waivers will unnecessarily increase the regulatory burden on APS and
11 Staff. It will do nothing to increase the "regulatory separation" of APS from its affiliates.

12 The most recent waiver of the Affiliate Rules granted to APS by the Commission,
13 and the only substantive one, was that granted by Decision No. 65434, which allowed the
14 emergency \$125 million backup line of credit. Although perhaps yet another unintended
15 consequence, the Recommended Order could effectively revoke this waiver, which was
16 only to be in effect for a year in any event. This already bizarre result is all the more
17 puzzling because that very waiver was approved by the Commission in an effort to
18 achieve the same objective professed in other portions of the Recommended Order, which
19 is the protection of APS and its customers from what Staff termed as "significant
20 problems." *See* Decision No. 65434 at 3.

21 In its Proposed Amendment No. 1, APS deletes the language in the Recommended
22 Order revoking its and PWCC's waivers of the Affiliate Rules and any accompanying
23 discussion. APS firmly believes this entire issue is not properly before the Commission,
24 and the record herein does not support taking the proposed action of revoking the waivers
25 in question. However, APS recognizes the Commission's authority in the area of affiliate
26 transactions. Thus, the Company is providing alternative language as part of Section IV of

1 its Exceptions that address the Company's waivers as well as other parts of the
2 Recommended Order relating to APS affiliate relations in a balanced and comprehensive
3 fashion.

4
5 **III. THE NEW RESTRICTIONS IMPOSED BY THE RECOMMENDED
6 ORDER ON APS AND ITS AFFILIATES SHOULD BE REJECTED**

7 The Recommended Order appears to require that every acquisition or divestiture of
8 "assets" by PWCC or PWEC would need "prior Commission approval." *See*
9 Recommended Order at 33. The same requirement is attached to any "pledge" or other
10 encumbering of "PWEC generation assets." *Id.* Although it is possible that the
11 Recommended Order was seeking only to restate what it believed were the existing
12 limitations of the Commission's Affiliate Rules, in fact, these requirements go far beyond
13 anything imposed even on public service corporations such as APS. Indeed, such a broad
14 limitation on the ability of non-utilities to acquire or dispose of non-utility property is
15 wholly without precedent anywhere in the United States.

16 Aside from the lack of notice and opportunity to be heard afforded APS, PWCC or
17 PWEC on these new restrictions, they are also direct violations of Section 4.4 of the 1999
18 APS Settlement Agreement, which provides that PWEC is to be regulated no differently
19 than non-affiliated generators. *See* Decision No. 61973, Attachment 1 at 7. And if taken
20 literally, or in the absence of some limiting definition, the former provision effectively
21 will prevent PWCC and PWEC from conducting their respective businesses. These
22 entities often acquire and sell literally dozens of assets on a daily basis, ranging from
23 turbines to typewriters. To require "prior Commission approval" for each such transaction
24 is so impractical as to warrant no further discussion.

25 Even if the first provision were limited to some threshold amount (for example,
26 Decision No. 58063 termed various investment thresholds as "exempt amounts" for
purposes of the Affiliate Rules), it is likely that the Commission would often have little

1 time to grant or deny such "prior approval." Purchases and sales are usually time-sensitive
2 transactions, and the Commission is already burdened with the responsibility of approving
3 certain sales of utility property under A.R.S. § 40-285, a process that often takes months
4 for a single transaction, without undertaking the significantly added responsibility of
5 supervising both sales and purchases by non-utilities.

6 The Recommended Order already requires that APS receive a senior security
7 interest in PWEC's Arizona assets as recommended by Commission Staff. This security
8 interest would prevent PWEC from disposing of or mortgaging the PWEC assets secured
9 by such loan or guarantee absent APS permission without either first paying off the loan
10 or releasing the guarantee.⁶ And if APS were for some reason to give such permission in
11 this case and in the absence of full repayment, its security interest would follow the asset
12 and be senior to any subsequent encumbrance.

13 Thus, it is difficult to see what purpose is served by either of these proposed new
14 restrictions on PWCC and PWEC other than to hobble unnecessarily their non-utility
15 business activities. They certainly do not provide APS with any additional "regulatory
16 insulation" as Staff discussed that term in either these proceedings or in Decision No.
17 65434. APS Proposed Amendment No. 2 deletes this recommendation and the
18 accompanying language in the Recommended Order.

19
20 **IV. THERE IS NO NEED FOR A "PRELIMINARY INVESTIGATION" OF**
21 **APS OR ITS AFFILIATES' COMPLIANCE WITH "DECISION NO. 61973,**
22 **THE ELECTRIC COMPETITION RULES, ITS CODE OF CONDUCT,**
23 **AND APPLICABLE LAW"**

24
25 It is not entirely clear what has prompted this suggestion in the Recommended
26 Order. However, APS will address what appear to be the identified bases for the

⁶ It is also not clear whether this restriction is intended to encompass Silverhawk, which would not be security for the APS loan under the Staff conditions. If so, its practical effect may be the same as the first proposed new restriction.

Recommended Order's concerns with the prior actions of APS, PWEC and PWEC, specifically:

- the proposed purchase by APS of power from its affiliates and the "dedication" of PWEC's Arizona generation to APS (Recommended Order at 34 and 36);
- the PWEC ratings agency presentation in February of 2001 (Recommended Order at 34- 35) and APS' filing of an air permit application on behalf of PWEC;
- the scope of and the Company's adherence to the APS Code of Conduct required by Decision No. 61973 and A.A.C. R14-2-1616 ("Rule 1616") (Recommended Order at 35, lines 18-20); and
- the potential for future subsidization of APS' spun-off generation assets by the use of an "unfair financial arrangement" between APS and PWEC (Recommended Order at 35-36).

A. APS Purchases from Affiliates and the "Dedication" of PWEC Assets

The Recommended Order states at page 20, in fn. 20, that "APS did not demonstrate that the Commission knew or approved that APS would or intended to purchase power from an affiliate." No such demonstration was proffered at hearing because none was ever requested. If it had, APS would have noted that Decision No. 61973 specifically found that APS purchases of electric energy from its affiliate would "benefit consumers," would not provide such affiliate with "an unfair competitive advantage by virtue of its affiliation with APS," and would be "in the public interest." Decision No. 61973, Attachment 1 at 7. Similarly, the 2001 APS Annual Report to the Commission under Rule 805 indicates in Exhibit 4 that APS purchased nearly \$50 million of power from an affiliate (PWCC).

As discussed above, APS' plans to purchase power from its affiliates had been expressly contemplated in and approved by the 1999 APS Settlement Agreement and disclosed in filings under Rule 805. They were also openly discussed with all the participants, including Staff, and without any criticism offered, in the Commission's 2001 Reliability Workshop. Moreover, such purchases were in accordance with PWEC's and

1 PWCC's market-based rate authority from the Federal Energy Regulatory Commission
2 ("FERC"), the filings for which at FERC had been provided contemporaneously to the
3 Commission.

4 And as to A.A.C. R14-2-1606(B) ("Rule 1606"), the Rule did not apply to APS
5 prior to 2003, and even thereafter, such Rule permitted up to 50% of APS' needs to be
6 provided by bilateral agreements that did not require competitive bidding. Nevertheless,
7 APS realized that any bilateral agreement with either PWCC or PWEC that extended
8 beyond 2002, and especially an agreement for more than 50% of APS' Standard Offer
9 requirements at what APS believed were below market prices, would need Commission
10 approval. And indeed the Company sought such approval in October 2001, some 15
11 months prior to the effective date of Rule 1606.

12 The Recommended Order also argues that the "dedication" of PWEC's Arizona
13 generation to APS is somehow "evidence" of the Company's "intended noncompliance
14 with the Commission's electric competition rules and/or possible anti-competitive
15 activity." Recommended Order at 34, fn. 18. What "possible anti-competitive activity" is
16 being referenced by the Recommended Order is left unexplained. As to "intended
17 noncompliance," this vague allegation is likewise unsupported by specific analysis of the
18 record. APS assumes the Recommended Order is speaking of Rule 1606, a Rule found
19 unlawful by the Superior Court and later revoked by the Commission itself in the Track A
20 Order (Decision No. 65154) prior to its becoming effective for even a single Arizona
21 electric utility.

22 In fact, such "dedication" of PWEC's Arizona generation was entirely consistent
23 with the Electric Competition Rules and, as it turned out, essential to meet APS
24 customers' needs. At no time prior to the Track A Order did APS have any contractual
25 obligation to purchase power from these units that extended beyond Rule 1606's then
26 effective date of January 1, 2003. PWEC further initially assumed that any sales to APS

1 would be at market prices, either through bilateral agreement or as a result of the 50%
2 competitive bidding provisions of Rule 1606. Even when it became evident in 2001 that
3 the wholesale market was unreliable and unacceptably volatile, APS sought an appropriate
4 variance to Rule 1606 as was its explicit right under A.A.C. R14-2-1614(C). APS also
5 clearly indicated that if the requested variance were not to be granted, it would proceed
6 with procuring power under Rule 1606 as written. And whether or not the Commission
7 agreed with the merits of the Company's variance request, which never received a
8 hearing, APS should not now be pilloried for trying to meet its customers' needs in a
9 reliable and cost-effective manner. Nor should its actions in that regard be characterized
10 as "intended noncompliance" with Rule 1606.

11 APS finds it more than ironic that during the drafting of these Exceptions, the
12 Commission issued its Track B Order in Decision No. 65743. That Decision repeatedly
13 emphasizes the duty of APS to provide reliable service at reasonable rates. The
14 Commission should be all the more wary of endorsing language that criticizes APS for
15 doing precisely that—particularly when there was presented no credible evidence that
16 APS could or should have performed any differently under the circumstances.

17 *B. February 2001 PWEC Ratings Agency Presentation*

18 The Recommended Order seemingly believes that PWEC misrepresented itself to
19 ratings agencies in its February 2001 ratings agency presentation or alternatively, unfairly
20 used APS "generation assets and captive ratepayers to gain advantage in the developing
21 competitive environment." Recommended Order at 34. Even if somehow relevant to this
22 Docket, such concerns are completely unsupported and, rather, are refuted by the very
23 record cited by the Recommended Order.

24 Not surprisingly, PWEC did represent to ratings agencies that the 1999 APS
25 Settlement Agreement authorized PWEC to receive the Company's generation on or
26 before 2003. This permitted PWEC to receive investment-grade ratings that: (1) were

expressly contingent on APS divestiture; and (2) were not in effect until such divestiture took place. There was nothing improper about that representation because it was unqualifiedly true at the time it was made. Indeed, it would have been improper to tell rating agencies anything to the contrary in view of Decision No. 61973.

PWEC also represented that it had the ability to sell power to APS consistent with Commission rules at market prices. Since the ability of APS affiliates to sell power to APS had been expressly approved by the Commission in the 1999 APS Settlement and had also been found by the Commission not to grant the Company's affiliate an unfair competitive advantage, this representation was also 100% accurate.⁷

Finally, PWEC represented that APS customers had first call on PWEC's generation through 2004 before any of it could be sold to the more lucrative markets in California and Nevada. (Tr. vol. III at 676, lines 4-23.) Although this commitment by PWEC for the sole benefit of APS customers may now be unappreciated with the benefit of hindsight, it was nevertheless true and remains true today.

PWEC anticipated that it would be assuming hundreds of millions of dollars of APS debt in conjunction with the receipt of the Company's generation assets. It also had to have the ability to fund needed new construction. Obviously, both these efforts would

⁷ The Recommended Order reflects considerable confusion on this point. PWEC assumed that its entire output would be sold to APS for 2001 and 2002, the two years prior to implementation of Rule 1606, at a market-based fixed price. PWEC further assumed that for the years 2003 and 2004, it could sell to APS, again at a market-based fixed price and either under an arms-length bilateral agreement or as a result of winning a competitive bid, 50% of APS requirements (per Rule 1606). (Tr. vol. I at 143, line 17 through 144, line 16; and also at 276, lines 1-16.) "The majority of [PWEC's] generation" (Recommended Order at 35, lines 11-12) would have been needed to fulfill 50% of APS' requirements. However, as APS witness Gomez testified, this was merely a "modeling assumption" by PWEC rather than a legal commitment by APS. (Tr. vol. II at 277, lines 15-16.) And because the modeled sales by PWEC were at the then projected market prices for the period 2001-2004, the specific identity of the buyer was largely irrelevant to the PWEC presentation. Moreover, the ratings agencies could and did make their own alternative assumptions about future market prices and markets for PWEC's generation, both under construction and to be acquired from APS. Thus, PWEC's final contingent ratings were based on the agencies' independent evaluation of PWEC's business prospects post-divestiture.

1 require PWEC to establish itself as a creditworthy business enterprise. This, in turn,
2 necessitated presentations and representations to the appropriate credit rating agencies.
3 None of the representations described above could be described as either inaccurate or an
4 example of affiliate abuse.

5 Although unrelated to the 2001 rating agency presentation, the Recommended
6 Order also cites at this same part of its discussion, and with apparent concern, the fact that
7 APS made application for a modification of an existing air permit at West Phoenix. *Id.* at
8 34, lines 10-11. The modification (not a new permit, as suggested by the Recommended
9 Order) in question was necessary to allow construction by PWEC of West Phoenix
10 Combined-Cycle Units 4 and 5. However, there was nothing particularly unusual about
11 APS' actions. County and state regulations required that the original permit-holder at this
12 site, which was and is APS, submit the application for such a modification. This is hardly
13 evidence of affiliate abuse. In fact, APS had to apply for the air permit revision used by
14 non-affiliate Pacificorp at Cholla 4 and holds the permits for all of the Palo Verde
15 participants, none of which is an affiliate, for precisely the same reason.

16 C. *APS Code of Conduct*

17 The Recommended Order quotes Decision No. 61973's language on the APS Code
18 of Conduct, which was required by both the 1999 APS Settlement Agreement and the
19 Electric Competition Rules. Such Code of Conduct was to address, among other topics,
20 "the supply of [APS] generation during the two-year period of delay for the transfer of
21 generation assets so that APS doesn't give itself an undue advantage over the ESP's." *Id.*
22 at 35. First of all, the generation being referenced in the passage is APS generation rather
23 than PWEC generation. Therefore, the relevance of the quote to the instant proceeding is
24 not clear. And if the Recommended Order is attempting to imply that the APS Code of
25 Conduct did not address the "supply of generation" relative to "ESP's," such implication
26

1 is not accurate.⁸ Section XI of the APS Code of Conduct approved by Decision No. 62416
2 specifically covers such “supply of generation,” and the Company has scrupulously
3 followed its requirements.

4 *D. Potential Subsidization of the Spun-Off APS Generation*

5 No APS generation was ever spun-off to PWEC or anyone else, so this quote in the
6 Recommended Order from Decision No. 61973 is again confusing. And, the “unfair
7 financial arrangement” spoken of in Decision No. 61973 referred to the concern of some
8 that APS would not transfer to its then unformed generation affiliate sufficient amounts of
9 the Company’s then outstanding debt. This explains the Commission’s reference therein
10 to “the capital structure of APS,” the lack of precise definition of “the assets it [APS] will
11 retain and which it will transfer to an affiliate,” and the post-divestiture “2004 rate case.”
12 The quoted language from Decision No. 61973 had nothing to do with post-divestiture
13 sales of power to APS, which were then to be governed by the Rule 1606 of the Electric
14 Competition Rules and any amendments or variances thereto.

15 *E. APS Proposed Amendment Nos. 3 and 3A*

16 Given the complete lack of evidentiary basis in this record for the proposed
17 “preliminary investigation,” APS Proposed Amendment No. 3 deletes those portions of
18 the Recommended Order. The Recommended Order’s arguments for this action, like those
19 for the summary revocation of the Company’s waivers, are based on incomplete
20 characterizations of the record or misunderstandings of the 1999 APS Settlement
21 Agreement.

22 If the Commission is still interested in a balanced and comprehensive review of the
23 Company’s activities during the past several years, APS would then offer an alternative to
24 its own APS Proposed Amendment No. 3. APS Proposed Amendment No. 3A retains the

25 ⁸ None of the intervenors in this proceeding are Electric Service Providers, or “ESPs.” Thus, again,
26 the relevance of both the quoted section of Decision No. 61973 and the Recommended Order’s discussion
thereof is not clear.

general concept espoused in the Recommended Order but substitutes the term “review” for “investigation.” The latter is a highly emotive word in these days of Enron, El Paso, etc., and will only serve to needlessly inflame a financial community already in turmoil regarding energy-related entities. APS Proposed Amendment No. 3 also deletes language prejudging the results of the review and further requires any such review to consider the needs of APS customers to receive reliable service. Once Staff has completed its review of past APS actions, the Commission can conduct a proper proceeding, if so desired, after proper notice to consider Staff’s recommendations concerning these matters, including but not limited to the status of APS and PWCC’s existing waivers of the Affiliate Rules. Further Commission consideration of the Staff review could take place prior to or in conjunction with the Company’s upcoming general rate proceeding.

V. THE LANGUAGE AT PAGE 36 OF THE RECOMMENDED ORDER, WHEN COMBINED WITH THOSE PROVISIONS ALSO SUMMARILY REVOKING PREVIOUS WAIVERS OF THE AFFILIATE RULES AND REQUESTING A PRELIMINARY INVESTIGATION INTO NON-EXISTENT VIOLATIONS OF COMMISSION RULES AND ORDERS, COULD BE CONSTRUED AS IMPROPERLY PREJUDGING ISSUES AFFECTING THE ACQUISITION AND RATEBASING OF THE PWEC ARIZONA GENERATING ASSETS

APS has already taken strong exception to language in the Recommended Order that accuses the Company of “intended non-compliance” and PWEC of using APS and its customers for some improper competitive advantage. But there is more at stake here than bruised feelings or even impugned character.

At page 41 of the Recommended Order, the last ordering paragraph states “that the issue of APS acquisition of Pinnacle West generation assets and rate base treatment is not presently before us, and we make no determination on those issues in this Decision.” And yet at page 36, the Recommended Order attacks the fundamental planning and business decisions that resulted in PWEC’s construction of the generation referenced in that quote. When this language is taken in combination with the equally unfounded criticism in the

Recommended Order of PWEC's unilateral "dedication" of these and other assets to APS (including temporary and permanent generation critical to meeting APS load in the Valley during 2001), the Recommended Order can easily be construed as having already determined in an adverse fashion some of the same factual issues that will necessarily affect the Commission's future deliberations on the acquisition and rate basing of PWEC's generation. Thus, APS finds it appropriate to address each of the Recommended Order's page 36 allegations.

Allegation No. 1 — The Commission Did Not "Require" APS or PWCC to Form an Affiliate to Acquire APS Generation Assets."

The Commission's Electric Competition Rules clearly required APS to divest its generation to either an affiliate or an unaffiliated third party. *See* A.A.C. R14-2-1615. Surely, the Recommended Order is not criticizing APS for not divesting its generation to one of the merchants in 2000. In turn, Decision No. 61973 required that such affiliate be a subsidiary of PWCC. Unless the Recommended Order is suggesting that APS generation should have been divested to SunCor or El Dorado, this required PWCC to form a new subsidiary, PWEC. And Decision No. 61973 further provided that the Commission would "approve the formation of an affiliate or affiliates of APS to acquire at book value the competitive service assets as currently required by the Electric Competition Rules [emphasis added]." Decision No. 61973, Attachment 1 at 5. To now suggest that the Commission had no role in PWEC's formation is simply belied by the facts.

Allegation No. 2 — The Commission Did Not "Require" APS to Purchase Power from an affiliate

This is literally a true statement, but ignores that such purchases were both contemplated and authorized by the Commission. Moreover, since APS would not have met its customers' needs without PWEC's generation, APS' only other alternative would have been to venture into a chaotic and dysfunctional wholesale market. And during "must-run" hours, even this market would not have been available for most of the

1 Company's load. Thus, APS believed that in a very real sense, it was required to maintain
2 its system through purchases from PWEC.

3 **Allegation No. 3 — The Commission has never reviewed the prudence**
4 **of building the PWEC assets nor did it know of or approve the**
5 **financing of such assets by PWCC**

6 The first part of this allegation is true but irrelevant to the financing request under
7 consideration in this proceeding, as is admitted by the Recommended Order itself at page
8 41. This is not to say the Commission was not fully aware of these assets' construction.
9 And at no relevant time did Staff or the Commission indicate that APS could or should be
10 constructing these assets at APS or that APS was acting improperly in relying on their
11 construction to meet its service obligation.

12 As to the financing of the assets, the Commission obviously did not "approve" the
13 debt of PWCC, although APS assumes that the Commission had to be aware that a billion-
14 dollar program would require financing. The PWCC financing program was disclosed in
15 filings with the Securities and Exchange Commission ("SEC"). These SEC filings were
16 routinely submitted to the Commission until they became freely available on the SEC's
17 website. *See* Decision No. 62748 (July 25, 2000) – repealing formal filing requirement in
18 lieu of electronic availability of SEC reports.

19 **Allegation No. 4 — APS Was Never Denied the Ability to Construct**
20 **New Generation**

21 The Recommended Order states that APS could and, by implication, should have
22 continued to construct new generation despite the Company's obligations under the
23 Electric Competition Rules and the 1999 APS Settlement Agreement to divest its
24 generation. Recommended Order at 26. As support, the Recommended Order cites Staff's
25 contention in its brief that "an examination of the document [the APS Code of Conduct]
26 does not clearly support that conclusion [that APS could not construct new generation]."

Id.

1 APS must respectfully disagree with the Recommended Order's interpretation of
2 the relevant documents, and the above quote is hardly a vigorous refutation by Staff of the
3 legal argument presented in the Company's opening brief, and which is repeated below.
4 However, the prohibition admittedly is not a straightforward proposition. It does require
5 an analysis of both the Electric Competition Rules and the APS Code of Conduct filed
6 pursuant to those Rules and Decision No. 61973, because neither of the two documents
7 alone tells the whole story. It also requires that one be familiar with the proceeding that
8 resulted in the Commission's approval of the APS Code of Conduct.

9 The point for beginning this analysis is the definition of "Competitive Service."
10 Generation is clearly a "Competitive Service" even when part of Standard Offer. *See*
11 A.A.C R14-2-1601(7) and (29). Section X (B) of the APS Code of Conduct prohibits APS
12 from engaging in "Interim Competitive Activities." "Interim Competitive Activities," in
13 turn, are defined by the Code as "Competitive Services, exclusive of those set forth in
14 A.A.C. R14-2-1615 (B) [which the Code of Conduct considers "Permitted Competitive
15 Activities], that APS may lawfully provide until December 31, 2002 [emphasis added]."
16 Although Section X (B) could be read literally as immediately prohibiting the Company's
17 continued ownership of its existing generation, the express extension of the divestiture
18 date in Decision No. 61973 to December 31, 2002 contradicts such a literal reading.
19 However, it was the clear understanding of APS at the time the APS Code of Conduct was
20 adopted that Section X (B) prohibited APS from building or acquiring new generation
21 except in conformance with Rule 1606.

22 Regardless of these Commission regulations and the provisions of the APS Code of
23 Conduct, it would have been ridiculous of APS to commit its resources into constructing
24 assets that for the most part would simply have had to be then divested to PWEC even
25 before they produced their first kWh. To have done so then would merely have
26 accelerated the need for this financing rather than avoided it.

1 Moreover, the entire regulatory paradigm underpinning the Commission's electric
2 industry restructuring efforts since early 1998 had been to encourage and even coerce
3 generation divestiture as quickly as practicable. And, given the tone of the balance of the
4 Recommended Order, APS finds it ironic that it would now be criticized for taking too
5 conservative an interpretation of its own Code of Conduct and of the Commission's
6 Electric Competition Rules.

7 In previous proposed APS amendments to the Recommended Order, APS has
8 proposed deletion of this unnecessary discussion. Thus, the Company does not have a
9 separate and discrete proposed amendment for this Section of its Exceptions.

10 **VI. CLARIFICATIONS OF THE RECOMMENDED ORDER**

11 *A. Scope of the Authority Granted*

12 The first ordering paragraph of the Recommended Order fails to expressly
13 authorize APS to loan the proceeds from the \$500 million debt offering to PWEC. The
14 Affiliate Rules require such explicit authorization for a loan under Rule 804(b)(2) in
15 addition to the authorization granted in the third ordering paragraph of the Recommended
16 Order pertaining to Rule 804(b)(1). APS Proposed Amendment No. 4 adds the needed
17 language to the Recommended Order.

18 *B. Precise Nature of the Conditions to the Authority Granted*

19 The Recommended Order states in its fifth ordering paragraph that the authority
20 granted by the Commission "is expressly contingent upon Arizona Public Service
21 Company's compliance with the conditions set forth herein and upon the use of the
22 proceeds for the purposes set forth in the application as modified herein." The second part
23 of this ordering paragraph does not present a problem, because both the proposed use of
24 proceeds described in the Company's Application and the Recommended Order's minor
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26

1 limitations thereon are clear. The first portion is potentially troublesome for each of the
2 reasons described below.

3 Lenders are obvious concerned with any provision that might qualify their ability
4 to receive payments under a loan. A.R.S. § 40-303(A) protects lenders who advance funds
5 in good faith from the subsequent failure of the utility to abide by conditions attached by
6 the Commission to financing authority. Because the statute uses the phrase "terms or
7 conditions" rather than "contingent," APS Proposed Amendment No. 5 substitutes the
8 word "conditioned" for "contingent."⁹

9 APS would also like to avoid a prolonged debate with lenders' counsel over what
10 was or was not intended by the Commission to be a "condition" to the loan. There are,
11 after all, some 40 pages of discussion prior to this particular ordering paragraph. APS
12 Proposed Amendment No. 5 expressly lists the seven Staff conditions that the
13 Recommended Order would attach to the authorizations granted.¹⁰

14 C. *Staff Condition No. 7*

15 The Recommended Order adopts Staff Condition No. 7, which imposes an
16 indefinite dividend limitation on APS. However, the second portion of that particular
17 "condition" is not a condition at all, but a process agreed to by Staff and the Company for
18 seeking a subsequent Commission waiver by APS of Staff Condition No. 7 for good
19 cause. *See* Recommended Order at 8. Approval of that specific waiver process, which is
20 not clearly mentioned in the Recommended Order, was critical to the Company's
21 acceptance of this Condition and to the Company's ability to justify and explain this
22 condition to the financial community. APS Proposed Amendment No. 6 adopts the

23 ⁹ APS views these terms as synonymous. However, persuading a prospective lender that there is no
24 difference is a needless complication to an already very tight schedule between now and the end of July
2003 when the first of the PWCC debt becomes due.

25 ¹⁰ To the extent that the Commission does not adopt the Company's Proposed Amendment No. 1,
26 these further conditions would also need to be listed at this juncture in the Recommended Order.

1 agreed-upon Staff procedure as a new ordering paragraph on page 41 of the
2 Recommended Order.

3 VI. CONCLUSION

4 APS agreed in principle with each of Staff's seven conditions at hearing and has
5 not submitted any exceptions to them now. Moreover, APS has dropped its objection to
6 the 264 basis point penalty attached to the loan of funds by APS to PWEC, even though it
7 continues to believe such a penalty is excessive and unwarranted under the specific facts
8 of this case.

9 The Company cannot, however, agree that an appropriate condition to receiving the
10 financing authority granted in the Recommended Order is the summary revocation of
11 previously granted waivers without appropriate notice, and without the effective
12 opportunity to present evidence supporting the continued need for such waivers. There is
13 simply no factual basis in this record for this precipitous action. Nor can it agree on behalf
14 of PWCC and PWEC to unprecedented new restrictions having no legal authority to
15 support them and which would be so onerous and impractical as to literally prevent them
16 from conducting their day-to-day business activities. And APS cannot agree to any
17 prejudgment of critical issues affecting its ability to fairly seek Commission authorization
18 to acquire and rate base the PWEC Arizona generation assets.

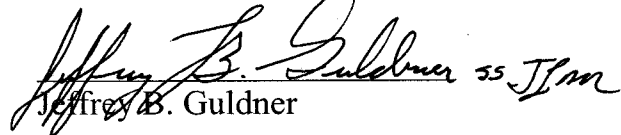
19 Finally, the Recommended Order is in need of certain technical amendments to
20 clarify and make explicit the scope of its authorizations, as well as the nature of the
21 conditions imposed on such authorizations. These latter three amendments also adopt the
22 process agreed to by Staff and APS as to the future consideration by the Commission of
23 any waiver requested by APS to Staff Condition No. 7.

24 Time has almost run out on this proposed financing. It will take literally every
25 remaining day to put together, market and close any debt issuance by either APS or
26

PWEC, as is authorized by the Recommended Order, prior to the first of the PWCC bridge debt maturing at the end of July 2003. Any further delay in ruling on the Company's Application would be tantamount to an outright denial. APS therefore urges the Commission to adopt the Recommended Order, as modified by the APS Proposed Amendments attached hereto as Appendix A.

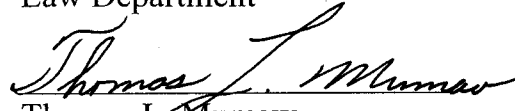
RESPECTFULLY SUBMITTED this 20th day of March 2003.

SNELL & WILMER L.L.P.


Jeffrey B. Guldner

PINNACLE WEST CAPITAL CORP.

Law Department


Thomas L. Mumaw
Karilee Ramaley

Attorneys for Arizona Public Service Company

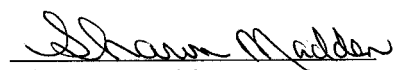
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Original and 13 copies of the foregoing
filed this 20th day of March 2003, with:

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, AZ 85007

Copies of the foregoing mailed, faxed or
transmitted electronically this 20th day of
March 2003, to:

All parties of record


Sharon Madden

Appendix A

**ARIZONA PUBLIC SERVICE COMPANY'S
PROPOSED AMENDMENT NO. 1
TO RECOMMENDED OPINION AND ORDER**

TIME/DATE PREPARED: March 20, 2003

COMPANY: Arizona Public Service Co.

AGENDA ITEM NO. U-1

DOCKET NO. E-01345A-02-0707

OPEN MEETING DATE: March 27, 2003

Page 31, Lines 6 to 8:

DELETE from "As indicated hereinafter..." to end of paragraph

Page 33, Line 28 to Page 34, Line 3:

DELETE "Further, we believe..." to end of paragraph

Page 39, Lines 16 to 17:

DELETE from "and that during..." to end of sentence

**ARIZONA PUBLIC SERVICE COMPANY'S
PROPOSED AMENDMENT NO. 2
TO RECOMMENDED OPINION AND ORDER**

TIME/DATE PREPARED: March 20, 2003

COMPANY: Arizona Public Service Co.

AGENDA ITEM NO. U-1

DOCKET NO. E-01345A-02-0707

OPEN MEETING DATE: March 27, 2003

Page 33, Lines 24 to 28:

DELETE from "We believe that..." to "...prior Commission approval."

Page 39, Lines 13 to 16:

DELETE from "that neither PWCC..." to "...prior Commission approval;"

**ARIZONA PUBLIC SERVICE COMPANY'S
PROPOSED AMENDMENT NO. 3
TO RECOMMENDED OPINION AND ORDER**

TIME/DATE PREPARED: March 20, 2003

COMPANY: Arizona Public Service Co.

AGENDA ITEM NO. U-1

DOCKET NO. E-01345A-02-0707

OPEN MEETING DATE: March 27, 2003

Page 34, Line 4 to Page 36, Line 15:

DELETE paragraphs

Page 39, Lines 24 to 26:

DELETE Finding of Fact No. 28.

Page 42, Lines 1 to 3:

DELETE ordering paragraph

**ARIZONA PUBLIC SERVICE COMPANY'S
PROPOSED AMENDMENT NO. 3A
TO RECOMMENDED OPINION AND ORDER**

TIME/DATE PREPARED: March 20, 2003

COMPANY: Arizona Public Service Co.

AGENDA ITEM NO. U-1

DOCKET NO. E-01345A-02-0707

OPEN MEETING DATE: March 27, 2003

Page 34, Line 4:

DELETE "Further, we" and REPLACE WITH "We"

Page 34, Line 4:

DELETE "preliminary investigation into" and REPLACE WITH "review of"

Page 34, Line 7:

INSERT after "Staff.": "Such review shall also place APS', PWCC's and PWEC's actions in the context of APS' need to provide reliable service to customers during this period and in the future."

Page 34, Lines 7 to 16:

DELETE from "Of concern..." to end of paragraph

INSERT "After such review has been completed and filed with the Commission, which shall occur within six months of the effective date of this decision, and after notice and opportunity for hearing being afforded to APS and PWCC as required by A.R.S. § 40-252, the Commission may consider whether any or all of the above-mentioned waivers should be modified or revoked in order to improve existing regulatory insulation of APS."

Page 34, Line 17 to Page 36, Line 15:

DELETE paragraphs

Page 39, Lines 24 to 26:

DELETE Finding of Fact No. 28.

INSERT New Finding of Fact "A review by Staff of APS' compliance with Decision No. 61973, the Electric Competition Rules, its Code of Conduct, and applicable law should be conducted within 6 months of the effective date of this decision."

Page 42, Line 1:

DELETE "preliminary investigation" and REPLACE WITH "review"

**ARIZONA PUBLIC SERVICE COMPANY'S
PROPOSED AMENDMENT NO. 4
TO RECOMMENDED OPINION AND ORDER**

TIME/DATE PREPARED: March 20, 2003

COMPANY: Arizona Public Service Co.

AGENDA ITEM NO. U-1

DOCKET NO. E-01345A-02-0707

OPEN MEETING DATE: March 27, 2003

Page 40, Line 22:

INSERT "and loan the proceeds to Pinnacle West Energy" AFTER "\$500,000,000"

**ARIZONA PUBLIC SERVICE COMPANY'S
PROPOSED AMENDMENT NO. 5
TO RECOMMENDED OPINION AND ORDER**

TIME/DATE PREPARED: March 20, 2003

COMPANY: Arizona Public Service Co.

AGENDA ITEM NO. U-1

DOCKET NO. E-01345A-02-0707

OPEN MEETING DATE: March 27, 2003

Page 41, Line 6:

REPLACE "contingent" WITH "conditioned"

Page 41, Line 7

REPLACE "herein" WITH "below in this ordering paragraph"

Page 41, Line 8:

INSERT following end of sentence: "The conditions are:

- (1) APS should be authorized to issue and sell no more than \$500,000,000 of debt in addition to its current authorizations;
- (2) The debt to be lent to PWEC should be no more than \$500,000,000 of secured callable notes from PWEC. The security interest shall be on the same terms as the security interest APS already has pursuant to the \$125,000,000 loan authorization from Decision No. 65434;
- (3) The PWEC secured note coupon shall be 264 basis points above the coupon on APS debt issued and sold on equivalent terms (including but not limited to maturity and security);
- (4) The difference in interest income and interest expense should be capitalized as a deferred credit and used to offset rates in the future. The deferred credit balance shall bear an interest rate of six percent;
- (5) The PWEC debt maturity shall not exceed four years, unless otherwise ordered by the Commission;
- (6) Any demonstrable increase in APS' cost of capital as a result of the transaction, such as from a decline in bond rating, will be extracted from future rate cases; and

- (7) APS shall maintain a minimum common equity of 40 percent and shall not be allowed to pay dividends if such payment would reduce its common equity ratio below this threshold, unless otherwise waived by the Commission. This condition shall remain in effect indefinitely and APS shall file with the Commission a calculation of capital structure within one week of filing a 10-K or 10-Q."

**ARIZONA PUBLIC SERVICE COMPANY'S
PROPOSED AMENDMENT NO. 6
TO RECOMMENDED OPINION AND ORDER**

TIME/DATE PREPARED: March 20, 2003

COMPANY: Arizona Public Service Co.

AGENDA ITEM NO. U-1

DOCKET NO. E-01345A-02-0707

OPEN MEETING DATE: March 27, 2003

Page 41, Line 9:

INSERT new ordering paragraph:

“IT IS FURTHER ORDERED that with respect to any waiver sought by Arizona Public Service Company under Condition No. 7, the Commission shall process such waiver request within 60 days and, for this 60-day period, the condition shall be suspended. However, Condition No. 7 shall not be permanently waived without an order of the Commission.”